

Message Text

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L-03 NSAE-00 NSC-07 PA-04 RSC-01 PRS-01 SPC-03 SS-20

USIA-15 AID-20 COME-00 EB-11 FRB-02 TRSE-00 XMB-07

OPIC-12 CIEP-02 LAB-06 SIL-01 OMB-01 AGR-20 STR-08

CEA-02 INT-08 IO-14 DRC-01 /226 W

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TO SECSTATE WASHDC 3597

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AMEMBASSY LONDON

AMEMBASSY PARIS

AMEMBASSY THE HAGUE

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USMISSION NATO

AMCONSUL GENOA

AMCONSUL MILAN

AMCONSUL PALERMO

AMCONSUL FLORENCE

AMCONSUL TRIESTE

AMCONSUL TURIN

C O N F I D E N T I A L SECTION 1 OF 2 ROME 3176

E.O. 11652: GDS

TAGS: PINT, IT

SUBJECT: SPLIT OVER ECONOMIC POLICY

REF: ROME 2947

1. SUMMARY: THE PRESENT GOVERNMENT CRISIS STEMS FROM DIVERGENCY

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ON PRINCIPLE OVER CONDUCT ITALIAN ECONOMIC POLICY. STABILIZATION

PROGRAM WORKED OUT WITH IMF PUTS ACCENT ON CONTINUED GROWTH, EVEN WITH CONTINUED INFLATION, AND PROBABLY COULD NOT BE MODIFIED MUCH IN DIRECTION FURTHER GROWTH ALONG LINES SOCIALISTS DESIRE. LA MALFA PROGRAM ENVISAGED ACCEPTING INFLATION UNTIL WORLD PRICES FALL AND HOLDING LIRA NEAR PRESENT DEPRECIATED LEVEL IN ANTICIPATION INCREASED EXPORTS LATER IN 1974, WITH GROWTH PROJECTED AT 4.2 PERCENT. SOCIALISTS WANT SIX PERCENT AND PUT LITTLE WEIGHT ON INFLATION AND DEPRECIATION LIRA AS LONG AS INDUSTRIAL WAGES CONTINUE TO RISE. THEY ARE NOT FULLY UNITED ON THIS POLICY, BEING PUSHED ON ONE SIDE BY TRADE

UNIONS AND ON THE OTHER BY ECONOMIC REALITIES. WE EXPECT ANY NEW GOVT WILL CONCLUDE STAND-BY ARRANGEMENTS, BUT WILL BE ALSO FACED WITH NEED AGREE TO FURTHER INCREASES IN SOME CONTROLLED FOOD PRICES. END SUMMARY.

2. THE IRONY OF PRESENT GOVERNMENT CRISIS IS THAT WHILE IT WAS BROUGHT ON BY DEEP AND IMPORTANT PHILOSOPHICAL DIVERGENCIES OVER ECONOMIC POLICY BETWEEN SOCIALISTS AND OTHER THREE MEMBERS OF CENTER-LEFT COALITION LET BY THE REPUBLICANS, IN PRACTICE THE SPLIT BETWEEN THEM HAD AND COULD ONCE AGAIN HAVE BEEN PAPERED OVER BY COMPROMISE. IT WAS LA MALFA, NOT THE SOCIALISTS, WHO BROUGHT UP THE QUESTION OF PRINCIPLE BY REFUSING TO ACCEPT SOCIALIST CONDITIONS FOR ACCEPTANCE OF THE IMF STAND-BY ARRANGEMENT: ACQUIESCENCE ACCOMPANIED BY MUTED CRITICISM OF LA MALFA'S ROLE IN NEGOTIATING THE STAND-BY AND ITS IMPLICATIONS FOR GOI ECONOMIC POLICY.

3. IT APPEARS TO US THAT THE STABILIZATION PROGRAM WORKED OUT WITH THE IMF IS DESIGNED TO TRY TO DO A FAIRLY REMARKABLE TASK OF RECONCILING GROWTH AND A MEASURE OF STABILITY. IT ACCEPTS, IN THE INTEREST OF AVOIDING DEFLATION AND BECAUSE OF INTRACTABLE NATURE OF PROBLEM, A VERY LARGE AND EXPANSIONARY BUDGET DEFICIT AND AN ONLY MODERATELY RESTRICTIVE CREDIT POLICY FOLLOWING ON A YEAR WHEN THE MONEY SUPPLY (SEPTEMBER TO SEPTEMBER) INCREASED 24 PERCENT AND MONEY WAGES IN THE INDUSTRIAL SECTOR (NOVEMBER TO NOVEMBER) INCREASED 24 PERCENT. IN STRIKING A BALANCE BETWEEN CONTINUED GROWTH AND STABILIZATION IT IS EVIDENT THAT GROWTH IS GIVEN PRIORITY. THE SOCIALISTS WANT IT GIVEN YET HIGHER PRIORITY. SINCE THE BALANCE STRUCK IS ALREADY MARKEDLY IN FAVOR OF GROWTH, WE WOULD DOUBT THAT ON SUBSTANCE THE FUND HAS MUCH GIVE LEFT ALTHOUGH SOME MODIFICATIONS ALONG THE LINES OF REFTEL ARE PROBABLY POSSIBLE. AN EQUALLY CONFIDENTIAL

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GOOD OBJECTION COULD BE MADE THAT THE STAND-BY IS HARDLY COMPATIBLE WITH STABILITY. HOWEVER, THIS MUST BE SEEN IN CONTEXT OF A UNIQUE PERIOD OF EXTERNALLY INDUCED PRICE INCREASES, ESPECIALLY FOR ENERGY WHERE ITALY IS PARTICULARLY VULNERABLE, AND OF A CONSEQUENT MASSIVE INCREASE IN IMPORT BILL.

4. THE WORKING ASSUMPTIONS OF THE LA MALFA SCHOOL WHICH ARE REFLECTED IN THE IMF LETTER OF INTENT APPEAR TO BE THE FOLLOWING:

THE MODERATE REDUCTION IN THE BUDGET DEFICIT CAUSED BY SOME TAX INCREASES TOGETHER WITH SLOWER MONETARY GROWTH WOULD REDUCE ECONOMIC ACTIVITY FROM AN EARLIER TARGET GROWTH RATE OF 6 PERCENT TO ABOUT 4.2 PERCENT. PRICES WOULD CONTINUE TO RISE AT AN ANNUAL RATE CLOSE TO 15 PERCENT IN THE FIRST PART OF THE YEAR. AVAILABILITY OF THE IMF STAND-BY ARRANGEMENT PLUS THE FURTHER EURO-DOLLAR BORROWINGS WHICH IT MAKES EASIER PLUS POSSIBLY A REVALUATION OF GOLD RESERVES AND THE PROSPECT OF SPECIAL BORROWING PERHAPS FROM THE IMF EARMARKED TO COVER OIL DEFICITS WOULD PERMIT HOLDING THE LIRA AT SOMETHING NEAR ITS PRESENT DEPRECIATED RATE (DOWN A WEIGHTED 20 PERCENT FROM A YEAR AGO, AND SEVEN-AND-ONE-HALF PERCENT IN 1974) UNTIL THE RESULTS OF THE DE FACTO DEVALUATION SHOW UP IN EXPORT PERFORMANCE DURING THE SECOND HALF OF THE YEAR. AT THE SAME TIME, THE CURRENT ACCOUNT SHOULD BE HELPED BY DECLINING PRICES OF INDUSTRIAL COMMODITIES AND FOODSTUFFS IN THE SECOND HALF, AND REDUCED IMPORTS BECAUSE OF MODERATED DEMAND AND DISHOARDING. THESE FACTORS WOULD ALSO MODERATE THE RATE OF INFLATION AND IMPROVE INDUSTRIAL PROFITS AND LATER INVESTMENTS. THIS SCENARIO OF COURSE DEPENDS ON MANY ASSUMPTIONS.

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C O N F I D E N T I A L SECTION 2 OF 2 ROME 3176

5. THE SOCIALIST SCENARIO IS DIFFERENT: MAINTAIN GOVERNMENT EXPENDITURE AT LEVELS SUFFICIENT TO OBTAIN THE TARGET SIX PERCENT GROWTH. THEY ARGUE THAT THE BUNCHING OF 1973 GROWTH IN THE LAST HALF OF YEAR MEANS THAT RATES MUCH LOWER THAN SIX PERCENT ARE EQUIVALENT TO ACCEPTANCE OF INDUSTRIAL STAGNATION. A FURTHER DEPRECIATION OF THE LIRA AND A MORE RAPID RATE OF INFLATION WOULD
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RESULT BUT THIS WOULD BE ACCEPTABLE AS LONG AS INDUSTRIAL WAGES ARE AT LEAST INCREASED PARI PASSU. AT SAME TIME INFLATION WOULD HAVE SAME EFFECT AS A WEALTH TAX ON HOLDERS OF MONEY AND THERE WOULD BE A DECREASE IN CONSUMPTION BY SECTORS OF THE ECONOMY OTHER THAN THE INDUSTRIAL. A FALL IN PRIVATE INVESTMENT WOULD BE COMPENSATED BY A RISE IN PUBLIC INVESTMENT SPENDING ORIENTED TO SOCIAL NEEDS. THE SOCIALISTS WOULD ALSO ARGUE THAT THERE REMAINS SUBSTANTIAL PRODUCTION SLACK IN THE ECONOMY, THAT INCREASED WAGES WILL CREATE LABOR PEACE AND HENCE INCREASED OUTPUT WITH EXISTING PLANT. WAGES INCREASES WOULD ALSO PROVIDE THE PURCHASING POWER TO CONSUME THE INCREASED OUTPUT, WHICH WOULD BE AT LOWER COST BECAUSE OF ECONOMIES OF SCALE. MOST OBSERVERS, OURSELVES INCLUDED, FIND THIS ANALYSIS ANPERSUASIVE, SINCE THE INFLATION IT IMPLIES COULD LEAD TO INCREASED CAPITAL FLIGHT, AND DRYING UP OF PRIVATE SAVING AND INVESTMENT WHICH THE STATE WOULD NOT REPLACE QUICKLY ENOUGH, IF AT ALL.

6. IF THE SOCIALISTS WERE TO PUT INTO PRACTICE THEIR STRONGLY EXPANSIVE PROGRAM LINKED TO LARGER BUDGETARY DEFICITS, THE RESULTS WOULD, IN THE UNLIKELY EVENT THAT MATTERS WERE CARRIED TO THEIR LOGICAL CONCLUSION, PROVOKE A POLITICAL AND ECONOMIC CRISIS AND EVENTUALLY A RECESSION. WE ARE NOT SURE HOW STRONGLY THEY HOLD THEIR DOCTRINE, SINCE IT IS INFLUENCED ON ONE HAND BY UNSOPHISTICATED UNION PRESSURES IN FAVOR OF HOLDING UP AN INCREASING REAL WAGES UNDER ALL CIRCUMSTANCES AND AT ANY COST, AND ON THE OTHER BY A STABLE OF FAIRLY CAPABLE PARTY ECONOMISTS WHO ADVISE POLITICIANS. THESE LATTER RECOGNIZE THE DANGERS OF APPLYING THIS POLICY AS GOSPEL, SINCE THEY ARE AWARE OF THE LINK BETWEEN WAGE COST AND INVESTMENT LEVELS, PRICE INCREASES AND THE BALANCE OF PAYMENTS.

7. BECAUSE THE FUND STAND-BY IS URGENTLY NEEDED (REFTEL), WE
EXPECT IT WILL BE CONCLUDED BY THE NEW CENTER-LEFT GOVERNMENT WITH
A CERTAIN AMOUNT OF ESSENTIALLY NON-SUBSTANTIVE MODIFICATION. THE
NEW GOVERNMENT WILL IMMEDIATELY FACE A SEVERE TEST OF PRICES:
THE PACKAGE OF SHARP INCREASES DECIDED FEB 20 (ROME 2512) HAS NOT
BROUGHT SOME PRODUCTS, PARTICULARLY EDIBLE OILS, BACK ONTO STORE
SHELVES IN GREAT QUANTITY AND SUBSIDY PAYMENTS FOR HARD WHEAT WILL
RAPIDLY EXHAUST
THE LIRE 100 BILLION SUBSIDY FUND. SHORT OF TAKING PUNITIVE
ACTION AGAINST MANUFACTURES AND DISTRIBUTORS TO ENFORCE
UNREALISTIC PRICE/COST RELATIONSHIPS, WHICH WOULD CREATE ANOTHER
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KIND OF POLITICAL PROBLEM, ANY ITALIAN GOVERNMENT FACES PROSPECT
OF FURTHER SHARP PRICE INCREASES IN KEY CONSUMER ITEMS IN NEXT
FEW MONTHS UNLESS THERE IS A RAPID AND DRAMATIC TURNAROUND IN WORLD
PRICES OF FOODSTUFFS. VOLPE

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